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# **RETHINKING INSURANCE REGULATION:**

## **VOLUME II PERSPECTIVES ON INSURANCE**

by  
**D. Joseph Olson**

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# RETHINKING INSURANCE REGULATION:

## VOLUME II PERSPECTIVES ON INSURANCE

D. Joseph Olson

I should begin by saying what an honor it is for me to be invited to deliver the keynote address at this important conference and by emphasizing the high regard in which I hold the Competitive Enterprise Institute. I have long been an admirer of Fred Smith, both for his work in the environmental policy area and for his development of CEI as a unique public policy organization. His success in attracting Catherine England to direct CEI's Insurance Reform Project is quite a coup. I have followed her work in the area of financial services regulation for many years and I am sure she is exactly the right person for this role.

I am also proud to have been an early supporter of the Insurance Reform Project; I think my former company was the second contributor to it, and I did what I could to encourage more insurance companies to support this project.

I might quibble a bit over the conference brochure's description of the project's goals and program, which are that policymakers, journalists, and the public be provided with substantive analysis of the way in which insurance markets work and the impact of various policy proposals. That is important, but there may be a more fundamental area which needs to be addressed: the targeted audience needs to be dissuaded from the current notion that insurance is somehow an exception to the ordinary laws of economics. That is, even among persons who would vehemently assert that they support free markets, there is a tendency to make an exception with respect to insurance and to support government "solutions" to "problems" in the insurance market. I will return to this subject in greater detail later.

The conference title, "Rethinking Insurance Regulation," might well have been the title of my remarks today. In the last ten months, since becoming Michigan's commissioner, I have done a lot of thinking and rethinking about insurance regulation. Fortunately, I have not "grown" during that process. That is, I have not moved away from my long-standing commitment to markets toward a belief that "experts" can manage a better outcome for both consumers and suppliers.

Instead, my thinking has been about the obstacles which confront a new commissioner who has a free market orientation and who wants to challenge the status quo approach to insurance regulation. I have also done some thinking about those who profess support for less regulation of insurance, thinking which together with experience has increased my skepticism about the sincerity of some of those supporters. And perhaps most important, I have thought a lot about what could be done to overcome those obstacles and about how to derive some benefits even from fair-weather friends of the market, not only in Michigan but across the country.

Assuming that my experience is typical — and I think it is — what situation confronts a new insurance regulator in this country? First is the entrenched position of what might be called the regulatory community. Insurance departments in the fifty states, the District of Columbia and various territo-

ries employ about 10,000 people. In addition, the National Association of Insurance Commissioners (NAIC) employs more than 300 people at its offices in Kansas City, New York and Washington, D.C. Many of these employees have held office for years, and they talk to each other, not only within each insurance department, but among the states and the NAIC. They develop relationships through these conversations and through what sometimes seems an endless series of meetings of the NAIC, its committees, subcommittees, task forces, and working groups.

It should surprise no one that the unstated consensus of opinion among this large group of people is that extensive regulation of insurance is just, proper, and necessary. I say this not from the point of view of the cynic who would say, "After all, their jobs depend upon regulation, so why wouldn't they be in favor?" That sort of self interest may of course play a role, but my experience convinces me that their motivations are more complex and their commitment to regulation is sincere. Against their experience and knowledge, it is difficult for a commissioner, especially one new to the field, to hold his own in discussions of controversial matters.

Against his own staff, or against the NAIC, the individual commissioner is clearly out-manned. Currently, the Michigan Insurance Bureau has 120 employees and only one unclassified position, that of the commissioner. Thus, the Michigan commissioner tends to be heavily dependent upon his civil service staff. He needs to bring considerable strength of character to the job, as well as a wealth of experience and a large body of insurance knowledge, if he is to chart an independent course.

Even with such attributes, some of which I modestly claim for myself, the task is not easy. After all, the commissioner's job is to enforce the insurance code and regulations. Since statutory and regulatory language is often general in nature, there is frequently room to "tilt" in favor of less regulation and more market freedom, but the amount of discretion tends to be limited. The commissioner cannot adopt obviously incorrect interpretations of the language, and he cannot simply ignore it. We have seen what happens when such efforts are made — at least it was alleged that Interior Secretary James Watt and EPA Director Ann Gorsuch were derelict in their duties to enforce environmental laws. The result was embarrassment for themselves and the president who appointed them.

Of course, a commissioner can propose changes in laws and regulation. And he has a "bully pulpit" from which to do so, especially if he is of the same political party as the majority in his state's legislature. Even then, he needs reasoned analysis to support his proposals if the legislature is to be persuaded to enact them. This is especially so since the proposals for less regulation usually meet with determined opposition, not only from those claiming to represent the supposed beneficiaries of regulation but also from regulated entities. Not infrequently, these opponents have more scholarly resources available to them than does the commissioner, not to mention more political clout.

The commissioner cannot ignore his own staff when he advances deregulatory proposals. Even though there may be some people who are supportive of less regulation and who will assist in analysis and lobbying, it is reasonably certain that a large proportion of any insurance department staff will resist the elimination or reduction of what they regard as necessary protection for consumers. And these people are the very ones upon whom the commissioner must rely to discharge his statutory duties to enforce insurance laws as currently written. This dependent relationship is likely to lead to a gradualist approach to deregulation, with a commissioner's proposals often being a compromise even before being sent to the legislature.

The final obstacle within this regulatory environment is the press of day-to-day business. While many duties may be delegated to deputies, the conscientious regulator cannot avoid involvement in many issues. His signature is required upon innumerable orders, and while his signature stamp may be handy for smaller and more routine matters, he cannot safely turn the signature completely over to others. And, of course, the tough decisions inevitably and properly wind up being passed on to the commissioner.

Collectively, in their NAIC roles, commissioners face similar problems. Fifty-five commissioners, serving, in effect, as the board of directors of the NAIC, have difficulty in managing the organization when they are dependent for information on a staff of more than 300 people, many of whom are more knowledgeable about insurance issues than most of the commissioners. The situation is very similar to that of a board of directors at a private corporation. Commissioners do not ask to be on this board and are not paid to be on it. Only a few commissioners have time to become seriously involved in NAIC matters. I note that these commissioners tend to come from smaller states or from larger states where they can rely on a number of political appointees upon whom they can rely or, perhaps, where they may have political ambitions and can use the NAIC as a vehicle to advance those ambitions.

The composition of the model laws and regulations which flow from the NAIC should therefore not be surprising. There are few, if any, proposals to reduce the involvement of regulators in scrutinizing the rates and policy forms used by insurers. I cannot recall many proposals to reduce barriers to entry to firms wishing to enter new markets. I cannot recall a model health insurance law which would reduce government involvement in health care or health insurance pricing.

Considering all these obstacles to a restoration of private markets, perhaps I should have titled this address "The Loneliness of the Free-Market Bureaucrat." But even though I may be lonely, I know I am not alone. I am sure that your free-market bureaucrat, if you have one, regards his plight as identical to what I have described.

Since I instinctively regard many of the notions of the majority of this regulatory community as incorrect, but always want to be sure that my reaction is more than instinctive, I did a small amount of research on the subject, particularly on the justifications for regulation. Typical justifications seem to be control of monopoly power; control of economic rents or "excessive profits;" or compensation for externalities, inadequate information, and excessive competition. Among these rationales, the only one which comes close to justifying insurance regulation, at least with respect to most modern markets, is that of inadequate information.

For a competitive market to function well, buyers must have sufficient information to compare competing products. In a well-functioning market, there should be as much information available as consumers are willing to pay for in order to lower the cost or improve the quality of their choices. It might be that, in some markets, the incentives to produce and disseminate information are not sufficient, perhaps because those in the best position to produce it may not do so or they fear that disseminating it may not benefit them. Or one of the parties to the transaction may seek deliberately to mislead the other by conveying false information or omitting key facts.

However, if these are the problems which justify regulation in insurance, one must question why the focus of such regulation is not to require or improve the disclosure of the pertinent information. (It seems to me that fraudulent or misrepresentational conduct is already regulated through the

judicial system, although conceivably some administrative regulation might reduce such conduct more effectively.) Most insurance regulation seems to focus not on increased disclosure and information, but rather on deciding in advance what choices consumers will be allowed to make “in their own best interest,” regardless of how much information they have. This approach suggests that the underlying reason for much insurance regulation, in spite of the information rationale, is pure paternalism. That is, many adherents of the current regulatory approach seem to assume that, even if consumers are provided with full information about their various choices, they are incapable of dealing with that information and making the “right” decision.

It is in such a regulatory environment that the press now characterizes as “free market” those commissioners who want to reduce the size of the NAIC staff and budget (from over 300 people to, say, 250 and from \$40 million to, say, \$30 million — some reduction!). Commissioners who want to resist the imposition of market conduct examinations on insurers doing business in their states and instead to continue focusing on solvency-related concerns are also considered “free market,” even though many of the solvency requirements are quite effective as barriers to entry, thus protecting current licensees from additional competition. And commissioners who are both regarded and self-described as “free market” are reluctant to allow, or even to discuss allowing, what Joseph Schumpeter described as the process of “creative destruction” to winnow out insurers whose owners and managements have been unable to deal with their asbestos and environmental exposures. The natural result of such a regulatory community is an environment in which the bias is toward regulation of markets, which are seen as so rife with “failure” that government must intervene in most areas. With these obstacles, it is a wonder that any commissioner is ever successful in changing anything — except perhaps adopting more regulation. Under these circumstances, how can we possibly restore private markets in public policy?

Fortunately, that is not the primary responsibility of regulators, although one might hope they would assist. Those that do become involved need allies. Where are these allies to be found? First, in spite of my description of most department employees’ attitudes, there are exceptions. Some harbor heretical sympathies for markets and will support changes if encouraged. Others are like the British civil servant is said to be, and they will work to implement a commissioner’s proposals even if not in personal agreement with them. These people need to be identified and cultivated.

Second, when one considers the amount of complaining by regulated entities about excessive regulation, one might assume them to be logical allies. To an extent, they are. I used to work for one, and we frequently took free-market positions which might not have been in our apparent short-term interest but which we saw as valuable in reaching our goal of a less-regulated market. Modesty prevents my holding myself out as a paragon of free-market virtue, but my company did consistently support measures which would deregulate markets. Further, mine was not a company which you would see making contributions to public policy organizations who oppose free markets; I am proud to say that on the Capitol Research Institute’s scale of one to seven (with one being extremely “liberal” and seven being

extremely “conservative”), my company’s average score was a six, and no contributions were made to the left of five. You see, *I* controlled the public policy contributions budget.

Having established my credentials, I must say that I have, in my brief commissioner career, observed a resistance to deregulation on the part of many regulated entities. Here are three quick examples:

First, the performance of the Michigan title insurance industry with respect to legislation which would deregulate title insurance rates is a case study of seeking regulation as protection from competition. A bill was introduced in the Michigan legislature to make title insurance rates negotiable. Ironically, the title insurance industry (mostly agents, but presumably representing companies) objected vehemently. I say "ironically" because in the late 1980s the staff of the Insurance Bureau discovered that title insurers were not charging the rates that they had filed with the Bureau. Instead, they were allowing non-filed discounts in great profusion. That is, they negotiated rates. The staff initiated a compliance proceeding and finally whipped the companies into filing all rates and discounts and adhering to them.

With this as background, you can appreciate a typical letter received by the sponsor of this bill. The writer stated that, when the Insurance Bureau initiated the enforcement proceeding, he was quite upset, believing that the bureau was interfering with competition to the detriment of consumers. He admitted, however, that he had now changed his mind, having found that filing rates and adhering to them "eliminates the fly-by-night operators who charge inadequate rates" and "prevents cash rich competitors from engaging in predatory pricing."

One might argue that since the loss ratio for title insurance in Michigan over the past three years has been less than three percent, and historically it has tended to be below five percent, that title insurance should not be regulated at all, or at least not regulated as insurance. Where would one find the supporters of title insurance deregulation? One is unlikely to find interest groups willing to commit their resources to supporting deregulation, whether it be rate deregulation or complete deregulation.

The story of surplus lines insurance in Michigan is my second example. The local industry group, consisting of producers, has been persistent in its desire for legislation establishing a "stamping office." All applications for surplus lines coverage would have to be submitted to this office, which would collect the taxes and verify that the application and coverages were "proper." All surplus lines producers in the state would be required to join the producers association, which would pay for the cost of the stamping office through dues and assessments. And I thought such "private regulation" went out in the late 1960s! I still remember visiting the Pacific Fire Rating Bureau with my fire underwriter trainer to argue over their criticisms of policies issued by INA, in the mid-60s.

My final example is the subject of continuing education for agents. Legislation mandating continuing education was enacted several years ago in Michigan, mostly through the efforts of an agents' association that wanted to offer courses and a state representative who had been a life insurance agent. He was quite open that his purpose in pursuing mandatory continuing education was to drive part-time agents out of the market, particularly those employed by A.H. Williams, which was at that time selling large volumes of term insurance under the "buy term and invest the rest" approach.

Legislation to add agency management to the list of topics that would satisfy continuing education requirements is now pending, but the Governor's office and I have proposed that, as the price of adding this subject, the continuing education requirement be sunset as of December 31, 1996. Who

most vehemently opposes this suggestion? Not the providers of education, who would seem to be the most immediately threatened beneficiaries, but rather agents, particularly life insurance agents, who argue that mandatory education is necessary to keep out the crooks and incompetents. Some are explicit in their belief that part-time agents form the majority of that group. (They usually don't mention competition.)

Although no study of which I am aware has ever shown that mandatory continuing education has had any measurable impact upon the competence and integrity of any regulated occupation, the absence of any strong interest group that would support an elimination of the requirement makes the prospects for our proposal questionable at best. So far, I find few legislative players who support proposals because they're the "right thing to do." (One might also question whether licensing itself makes any sense — see Milton Friedman's *Capitalism and Freedom* — but that's a battle for another day.)

I think perhaps you can see the source of my skepticism about the degree of industry commitment to markets as opposed to regulation. I sometimes wonder what might happen if advocates of extensive regulation within the "regulatory community" were to ally themselves with those private sector groups. Perhaps my next speech to CEI, after being forced from office, could be titled "The Revenge of the Rent Seekers."

All this is not to say that, mostly on an ad hoc basis, industry allies cannot be found. The Michigan Legislature recently passed a bill that eliminates the restrictions on territorial rating for automobile and homeowners insurance. For the most part, insurance companies supported it, although I understand there was some resistance to the elimination of territorial rating constraints from insurers who saw competitors being disadvantaged by these constraints.

Legislation to extensively deregulate forms and rates is also about to be introduced in Michigan, with the support of most insurance companies. However, since this legislation would completely eliminate filings of rates and forms for all commercial lines of insurance, in the absence of a finding by the commissioner that there exists a lack of competition for a particular line or type of insurance, I am interested in seeing the result. What, for example, will be the reaction of about companies who adopt a "copy cat" approach to rating and for whom immediate access to competitors' filings is no longer available?

Other possible allies in deregulation efforts include legislators dedicated to limited government and free markets. Unfortunately, I have found that many legislators who would never support price controls in other areas, such as housing rents, do not hesitate to vote in favor of price controls in the insurance field. For example, in 1992 large majorities of Republicans and Democrats in the House and Senate in Michigan voted to reduce auto insurance rates by fifteen percent as part of a "reform" bill. However, the bill included so few "reforms" to reduce the cost of what insurance pays out that few observers thought that loss costs would decline by more than one percent. (This comment about reducing loss costs attributes inappropriate merit to the notion that including cost reductions in legislation justifies price controls.) Fortunately, Governor Engler vetoed the bill. What is particularly noteworthy is that the same legislature which voted for these insurance price controls also passed legislation that prohibits local governments from instituting — you guessed it — housing rent control.

There are, of course, some legislators who are solidly in favor of free markets. However, they may not even be a majority of the Republican caucus in the Michigan Senate, comprised of 22 Republicans and 16 Democrats. Free-market legislators are clearly not a majority in the House, which is comprised of 56 Republicans and 54 Democrats.

At the beginning of my remarks, I told you I had thought about how to overcome all these obstacles and more or less implied that I would give you the results of that thinking. To some extent I have, by mentioning the availability of allies on insurance department staffs, among industry groups at least on an ad hoc basis, and among legislators. Before I move on to the rest of those thoughts, let me briefly digress.

So far, I have spoken mostly about state regulation, even though the program for today's conference states that it will focus on questions that transcend state boundaries and gain the attention of both federal and state policy makers. My emphasis has been upon the areas which, for me, are where the action is. Although many of the subjects of today's conference are federal, I expect that for the foreseeable future most insurance regulation will take place at the state level, so I do not intend to address most of the scheduled issues at this conference, except to comment that some might have the potential for increasing regulation, not restoring private markets, and for doing so at the worst possible level of government.

I cannot pass up an opportunity to ask you to consider a proposal the Michigan Insurance Bureau has been advancing for several years. When I suggest that federal regulation of insurance would be inappropriate, I do not mean to imply there are not some areas of regulation that should more appropriately be undertaken at the *national*, not the state, level. Note that I said "national," not federal. There are many large insurers, both U.S. and foreign, whose business operations are truly national or international. Their customers are corporations doing business in many states and countries. Regulating such companies at the state level has created many problems.

For example, some states have suppressed insurance rates in a way that has tapped the capital of the national insurers to support low rates for local voters. Another problem is that when a large national insurer gets into financial difficulties, the home state, which has primary control of any receivership, may be tempted to use its control over the national assets and organization to favor local employment, local interests, and local policyholders at the expense of guaranty funds, policyholders, and employment in other states. For insurers domiciled in foreign countries, requiring a certificate of authority from each state creates a barrier to entry, even if the fact that U.S.-based insurers are treated the same prevents this requirement from being a "non-tariff barrier" under international trade law.

The need for national regulation for national and international insurers, and local regulation for others, could be addressed by an interstate compact in which, of course, membership by individual states would be optional. Insurers licensed in any state joining the compact could have the option of electing to be regulated by the compact (in areas of regulation delegated to it by compacting states). At the same time, insurers who prefer state regulation could opt not to choose compact regulation and instead continue the status quo. In all likelihood, the AIG's of the world would choose the compact, especially if it were enacted in many states, while many single-state and regional companies might choose the current system.



This Michigan Insurance Bureau proposal would also allow insurers an explicit role in deciding compact policy. They obviously play a role in developing regulatory policy on a state-by-state basis today, but it is done through ordinary lobbying. Why not give them an express and public role, in which they can provide their input and be responsible?

This optional compact would also have the advantage of setting up two systems that might well compete with one another to attract companies. I think, but cannot guarantee, that this competition would usually tend to produce more enlightened, less intrusive regulation. I recognize the risks, based upon what I said earlier, that some of the competition between the two systems might take the form of offering companies protection from competition in the marketplace.

But I have digressed. I mentioned earlier that the free-market regulator needs allies, as do similarly inclined legislators and state government officials. The need for such allies, and the support they can bring, is the reason I have been so supportive of CEI's insurance reform project. As I said earlier, I think that the program brochure's description in a sense misrepresents the project's goal. I think its goal actually is, or certainly should be, to assist in dispelling the prevailing myth about insurance. So stated, the goal is more fundamental than portrayed in the brief paragraph in the brochure.

The intellectual support provided for market-oriented state regulators and legislators from CEI's insurance reform project will be invaluable. I have seen drafts of Catherine's primer on the business and regulation of insurance and know that it will make a contribution toward changing thinking, but it is only a first step. We also need and I expect a series of monographs from CEI on specific insurance issues, similar to monographs already produced about redlining and cost-based pricing.

Such scholarly works would compensate for the shortage of market-oriented employees in state insurance departments. For this reason, I would expect that representatives of insurance companies in this audience would recognize the value of such works and encourage the appropriate level of financial support for CEI. Even if you perhaps occasionally engage in rent-seeking behavior, I think most of you retain a basic orientation in favor of markets and should be supporting research in that area.

As I said, however, most of the action remains at the state level, and individual states have unique problems. I have already spoken to Fred Smith about this, and do not want to put him on the spot by outlining my ideas today, but I will. Those ideas derive from the fact that there exists in this country an extensive network of state-based think tanks, all focusing upon state-specific public policy issues and approaching them from a free-market point of view. Most of the larger states now have such institutes, but the most successful, in my obviously unbiased opinion, is that in my own state — The Mackinac Center for Public Policy. I say "obviously unbiased" because I have been able to rise (I almost said "grow") beyond the fact that I was involved in its founding and served as its first board chairman, from 1987 until my appointment as insurance commissioner in 1995.

We need to develop cooperative relationships between such state-based think tanks and CEI. It seems a good fit. CEI can use its resources to look at broad economic themes in the area of insurance regulation, and the state-based organizations can rely upon this body of work and fit it to their specific local situations. I assume that there would be constant communication between the staffs of CEI and these state organizations, similar to that which exists between the employees of state insurance departments and the staff of the NAIC.

Research and analysis in the world of ideas is important because politicians who impose regulations are followers, not leaders. They respond to the climate of opinion which dominates any particular era, what Hillsdale College President George Roche calls society's "governing myths." His ideas draw upon the works of Nobel prize-winning economist Friedrich Hayek who, in a 1949 essay entitled "The Intellectuals and Socialism," outlined the manner in which intellectuals, whom he described as "second hand dealers in ideas," influence the climate of opinion in any particular society at any particular time. By intellectuals, Hayek refers neither to original thinkers nor to scholars or experts in any particular field of thought. Rather, the intellectual qualifies as such by the wide range of subjects on which he can readily talk and write, even without any first hand expertise.

The class includes journalists, teachers, ministers, lecturers, publicists, writers of fiction, cartoonists, and artists, any of whom may be experts in the technique of conveying ideas but are usually amateurs as far as the substance is concerned. Summarizing, Hayek contends that "these intellectuals are the organs which modern society has developed for spreading knowledge and ideas, and it is their convictions and opinions which operate as a sieve through which all new conceptions must pass before they can reach the masses."

From the title of the essay, you may conclude that Hayek posited that, at least in 1949, socialist ideas were widely held by intellectuals. While there may have been some improvement in this situation during the past forty-five years, I think it is still true that many socialist notions are held even by some of socialism's opponents. As Hayek commented, "with many of the more general preconceptions of socialist thought, the connection of their more practical proposals is by no means at once obvious; in consequence, many men who believe themselves to be determined opponents of that system of thought become in fact effective spreaders of its ideas. Who does not know the practical man who in his own field denounces socialism as 'pernicious rot' but, when he steps outside his subject, spouts socialism like any left journalist?" This phenomenon may explain the votes of "free market" legislators in favor of price controls.

For our purposes, the single idea of socialism which is most prevalent in those who think about insurance regulation is the notion that, in light of scientific accomplishments in other fields, surely society can be centrally planned and managed by a body of intelligent, knowledgeable people. Current ideas of regulation typically spring from the belief that, in Hayek's words, "deliberate control of conscious organization is also in social affairs always superior to the results of spontaneous processes which are not directed by a human mind, or that any order based on a plan laid down beforehand must be better than one formed by the balancing of opposing forces." That particular legacy of socialism must be discredited before we can achieve the explicit goal of this conference, restoring private markets.

Ultimately, we can restore private markets in insurance and dispel the prevailing myths about the institution only if we can win this war of ideas. And there are massive resources arrayed against us, not only the government and rent-seeking private forces I mentioned, but also academics and leftist think tanks who view regulation more favorably than we.

Private contributions to organizations such as CEI and the Mackinac Center are unlikely ever to generate the level of financial resources available to opponents of markets. But we have already seen examples, such as the influence of the Heritage Foundation on the Reagan administration and the

Mackinac Center on the Engler administration, of relatively small funding targeted at specific areas having a dramatic effect.

Today's conference should be merely a beginning for those of you who are truly committed to limited government and free markets instead of interventionist regulation. For this beginning I would once again like to thank the Competitive Enterprise Institute, and particularly Fred Smith, for making this conference possible and for allowing me to provide my perspectives on insurance regulation.

#### **ABOUT THE SPEAKER**

D. Joseph Olson is Vice President and General Counsel for the Amerisure Companies. Mr. Olson is responsible for all legal matters other than non-litigated claims, for human resource matters and for government and industry relations. From 1995–1997 Mr. Olson was Commissioner of Insurance for the Michigan Insurance Bureau. He served as chief insurance regulator and manager of agency with 124 employees, annual budget of \$14 million, overseeing regulated entities writing over \$30 billion in annual premiums in the state. Mr. Olson also served as rehabilitator and liquidator for companies in receivership. In 1965, Mr. Olson received his B.A., magna cum laude, in Political Science at Oklahoma City University and in 1975 his J.D., summa cum laude, at the University of Santa Clara (California).

